No. 11626

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

LILY HO QUON and ALBERT T. QUON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Upon Petition to Review Decisions of the Tax Court of the United States

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OPENING BRIEF FOR PETITIONERS.

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Jurisdiction.

The jurisdiction of this Court is invoked under Section 1141 of the Internal Revenue Code. This appeal is from decisions of the Tax Court of the United States determining deficiencies in federal income taxes of each of the petitioners for the calendar year 1941. The petitioners are individuals residing in Los Angeles, California [R. 32].

Question Presented.

The sole question presented is whether the distributive shares of four trusts in the earnings of a certain business, the Quon-Quon Company, are includible in the gross income of petitioners under the income tax provisions of the Internal Revenue Code.

Statutory Provisions Involved.

The decision of the Court below was rested solely on *Commissioner v. Tower*, 327 U. S. 280, and *Lusthaus v. Commissioner*, 327 U. S. 293. The statutory provisions involved here are the same as involved in those cases. They are Sections 11, 12, 22(a), 181 and 182 of the Internal Revenue Code. Those provisions are shown in the appendix hereto, pages 1 and 2.

Statement of Facts.

1. Petitioners are husband and wife residing in Los Angeles, California. Unless otherwise indicated, the term "petitioner," in the singular, will be used herein to refer to Albert T. Quon. Petitioner is a resident alien. Petitioner Lily Ho Quon is a citizen. Prior to May, 1941, petitioners owned, as community property [R. 38], a business operated as a sole proprietorship of petitioner under the name of Quon-Quon Company. The business involved importing Chinese decorative merchandise and wholesaling it [R. 32].

2. On May 1, 1941, petitioners, as co-trustors, created four separate trusts, one for each of their four minor children. These children were all citizens. Concurrently with the creation of these trusts Quon-Quon Company was reorganized as a partnership, petitioners being constituted general partners and the trustees of the four trusts being constituted limited partners [R. 32].

The Trusts.

3. The four trusts, in so far as here material, are essentially similar except for the identity of the beneficiaries and trustees [R. 32]. Petitioners, as co-trustors, irrevocably assigned to each trustee a 12½% interest in

the said Quon-Quon Company [R. 32]. Under his respective trust instrument each trustee was required to invest such 12½% interest as limited partner in the limited partnership into which, as above stated, the Quon-Quon Company was then reorganized. It was also required that his corresponding share of the profits be credited to him and "distributed to him from time to time, pro rata with distribution to the general partners" [R. 33].

4. Each trustee was "vested with power," upon dissolution of said partnership, "to reinvest his distributive share of the proceeds therefrom, or any part thereof, in the capital assets or capital stock of any partnership, corporation or other company which may be organized for the purpose of acquiring the assets and continuing the operation of said business" [R. 33]. There is no provision requiring him so to reinvest his distributive share of the proceeds of dissolution, or any part thereof.

5. Each trustee was further authorized "to sell or exchange trust assets, purchase other assets, invest trust funds or borrow money and obligate or encumber the trust estate therefor, all only with the written consent of the beneficiary after he attains 21 years of age or only with the written consent of the beneficiary's parents prior to such time" [R. 34].

6. Payments to the beneficiary of each trust out of accumulated income and principal of the trust estate were to begin when such beneficiary reached 21 and distribution of the entire income and principal was to be completed when he reached 35. If a beneficiary died before reaching 21 the trust estate was to go to *his* issue, or, if none, equally to the remaining trusts. If he died after reaching 21, the trust estate was to go to *his* heirs, devisees or legatees [R. 34]. There is no other provision for the

beneficial use of either the income or the principal of the trust estate. The trustors reserved no interest of any kind.

7. Each trustee was entitled to compensation for ordinary and usual services of $50 a year. In the event of his absence from the state for an extended period of time a co-trustee could be appointed by a *competent court* to act during such period of absence. If a trustee resigned only a *competent court* could appoint a successor [R. 35].

The Partnership.

8. In the limited partnership into which the Quon-Quon Company was reorganized the petitioners became general partners, each with a 25% interest, and the four trustees of the four trusts became limited partners, each with a 12½% interest.

9. The partnership is for a term of 25 years. It can be dissolved by the death of a general or limited partner, or by the "withdrawal from the partnership of any general or limited partner" [R. 35]. Upon such dissolution of the partnership and the liquidation of its assets the pro rata shares of the limited partners in the assets of the partnership are to be returned to them [R. 36].*

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*The findings show no limitation on the right of any general or limited partner to withdraw, although the copy of the partnership agreement set forth in the pleadings [R. 24] states that two months' written notice to the remaining general and limited partners is required. If the certificate of co-partnership does not otherwise specify, six months' notice is required. California Civil Code, Section 2492(2)(c).

Events Leading up to Formation.

10. In 1940 petitioner went to China to purchase merchandise for the business and was absent from this country approximately from April to August, inclusive, or about five months. During this period an employee named Fung "was in control of the business and operated it" [R. 36].

11. After petitioner returned from China in August, 1940, he became "concerned over the possibility that his business assets might be frozen by executive order since certain alien property in this country was becoming subject to such controls. Early in 1941 petitioner discussed the problem with various friends and advisors. The plan to create the trusts and the partnership, which was executed May 1, 1941, grew out of these discussions" [R. 36]. Since petitioner's children and wife were citizens, partial ownership of the business assets by them was considered a practical method of avoiding seizure to such extent [R. 37]. An additional factor considered in arriving at the plan was petitioner's parental desire to make provision for the security of his children. Another was reduction of taxes [R. 36-37].

Conduct of Business After Formation.

12. After the creation of the partnership the manner of conducting the business was the same as prior to the partnership [R. 37]. Thus, as in 1940, petitioner purchased merchandise for the business; and during his absences in that connection an employee such as the one

named Fung was in control of the business and operated it.*

13. After the creation of the partnership, however, there was a vital change in the residence of the power over the business. Thereafter any one of the trustees could withdraw his interest and thereby cause a dissolution of the partnership and liquidation and distribution of its assets [R. 35, 36. See also paragraph 9 above].

14. After the creation of the partnership, moreover, there were vital changes in the control and application of the earnings of the business. Petitioner received a salary from the partnership of $4,000 for the eight-month period from May 1 to December 31, 1941, or $500 per month. This was deducted in arriving at the net profits of the partnership [R. 37-38]. Petitioner could not draw against his share of the net profits without making pro rata distributions to the four trusts [R. 33]. Such distributions were made. At first such distributions to the trusts were made by purchase of securities for them and delivery thereof to the trustees. Later the trustees themselves directly purchased securities for the trusts from their distributive shares of net profit credited to them on the partnership books [R. 37].

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*While the findings make no mention thereof, this Court will undoubtedly interpret the findings in the light of the substantial closure after 1940 of China to import trade, and the necessary diversion of importation trips thereafter to such foreign countries as remained effectively open.

Specification of Errors.

1. The Tax Court erred in holding that this case falls within the scope of *Commissioner v. Tower,* 327 U. S. 280, and *Lusthaus v. Commissioner,* 327 U. S. 293. The Tax Court rested its opinion solely on those cases. But the rationale of those cases has no application to the facts here.

2. The Tax Court erred in entering its decision in each of the dockets included in this proceeding wherein it ordered and decided in each such docket that there is a deficiency in income tax of $9,835.08 for the year 1941.

Summary of Argument.

Under the Internal Revenue Code the net income of an individual who is a partner is expressly required to include his distributive share of the net income of the partnership. Therefore, the distributive share of each trust in the net income of the Quon-Quon Company was taxable to it and not to petitioners.

The exception of certain partnership interests created by intra-family gift from the scope of this statutory requirement under the doctrine of the *Tower* and *Lusthaus* cases has no application here. In those cases there was, in the guise of a partnership, a mere paper reallocation of income between husband and wife. Here the change was in economic realities. The trusts became the absolute owners of the partnership shares which they acquired and the recipients of the economic benefits flowing therefrom.

A. By Express Statutory Provision the Distributive Share of Each Trust as Limited Partner in the Net Income of the Quon-Quon Company Was Taxable to Such Trust and Not to Petitioners.

As shown in the appendix, page 2, Section 182 of the Internal Revenue Code expressly provides that the net income of a partner shall include, whether or not distribution is made to him, his distributive share of the net income of the partnership. It must follow that that distributive share of each trust involved here in the net income of Quon-Quon Company was taxable to such trust and not to petitioners.

B. Exception From the Above Statutory Provision, of Partnerships Constituting a Mere Paper Reallocation of Income, Has No Application Here.

This exception is the product of the cases of *Commissioner v. Tower,* 327 U. S. 280, and *Lusthaus v. Commissioner,* 327 U. S. 293. In the *Tower* case the taxpayer, sole owner of a corporation except for a 1% interest in his wife and a 10% interest in one Amadon, transferred another 38% to his wife, retaining the balance of 51%. and then converted the corporation into a partnership. The question was whether the income attributable to the wife's share under the partnership agreement was taxable to her husband. The reason for forming the partnership was that it "would result in tax savings and eliminate the necessity of filing the various corporate returns." The partnership was to last for twenty years unless sooner terminated by a decision of a majority in interest of the partnership capital. As stated above, the husband held 51%. No salary was paid to the husband before determining the amount of the profits to be distributed. In

fact, Amadon's share of the profits was adjusted so as indirectly to preserve Amadon's previous salary and at the same time throw the amount previously paid the taxpayer as salary into the portion of the profits to be shared between the taxpayer and his wife. The wife's share of the earnings, the Supreme Court held, was "income produced by the husband's efforts." The Court also stated:

> "The wife drew on income which the partnership books attributed to her only for the purposes of buying and paying for the type of things she had bought for herself, home and family before the partnership was formed. Consequently the result of the partnership was a mere paper reallocation of income among the family members. The actualities of their relation to the income did not change."

In the *Lusthaus* case a husband-wife partnership was likewise involved. There also the question was whether the income attributable to the wife's share under the partnership agreement was taxable to her husband. There the purpose was also entirely to reduce income taxes. There likewise the wife could not withdraw her interest without her husband's consent. There also the husband drew no salary. There, too, the wife's withdrawals of earnings were not used or held for her separate benefit. They were used largely to pay back some of the notes given by her to her husband in part payment of the purchase price of her alleged contribution to the partnership capital.

In these cases the Supreme Court, by way of illustration, pointed out factors which the Tax Court *could* properly take into consideration in determining that a partnership was real for tax purposes. But in neither one did it lay down conditions which *must* appear in order that a

partnership be considered real for tax purposes. The Supreme Court laid down no categorical imperatives. The issue was one between reality and fiction. Reality cannot be cast into any fixed and narrow mold. The Supreme Court made no attempt to do so.

Comparing now the *Tower* and *Lusthaus* cases with the case at bar, those cases are seen to be distinguishable in every material factor. The distinctions are as follows:

1. In the *Tower* and *Lusthaus* cases the income involved was the distributive share of the wife. Here it is the distributive shares of trusts for minor children. What husband and wife may do with their money as between themselves is entirely a matter between themselves. What parents may do with the property of their children is a wholly different matter.

In *Cushman v. Commissioner* (C. C. A. 2), 153 F. (2d) 510, the question involved taxability to the grantor of the income of a trust in which the beneficiaries were the grantor's children. The Court there, distinguishing *Helvering v. Clifford,* 309 U. S. 331, in which the beneficiary was the grantor's wife, stated that the particular relationship of the beneficiary to the grantor is important in determining whether "the grantor has retained the economic benefits of the property transferred in trust."

In California a parent as such has no control by operation of law over the property of the child. Civil Code of California, Section 202. If he is made guardian he is liable as trustee and is subject to regulation and control by the Court. Probate Code of California, Section 1400. If under a trust instrument he holds a power for the benefit of the trust he, as any one else, is with respect to the exercise of such power liable as trustee; and the express trustee may reject his attempted exercise of such

power in violation of the fiduciary relation. American Law Institute, Restatement of Trusts, Section 185; *Cushman, Jr., v. Commissioner, supra.*

Here, then, the income involved was in a wholly different position from that involved in the *Tower* and *Lusthaus* cases. Here it was not that of a wife, which might be subject to the husband's command. Here it was that of minor children, protected by trustees, a separate trustee for each child, and protected further by the special solicitude of the law. The exclusion of this income from the parent's dominion could not be greater if it were owned by total strangers.

2. In the *Tower* and *Lusthaus* cases the sole purpose was tax saving. Here the originating and primary purpose was protection of the business from destruction by freezing orders. The Tax Court found this as a fact. It made no finding that the transfers of interest were a sham, or that they were not *bona fide* and valid. On the contrary, it found as a fact that the petitioners, as co-trustors, "created four separate trusts," and "irrevocably assigned" the interests involved to the respective trustees. It found as a fact that concurrently "with the creation of these trusts Quon-Quon Company was reorganized as a partnership, petitioners being constituted general partners and the trustees of the four trusts being constituted limited partners." It found as a fact that the partnership could be dissolved by the "withdrawal from the partnership of any general or limited partner." It found as a fact that the distributive share of each trustee in the net income of the partnership was required to be distributed to him "pro rata with distribution to the general partners." It found as a fact that such distributions were actually made and that the amounts of such distributions were invested

by the trustees in securities. Every finding bears out and emphasizes the utter honesty and completeness of the transfer of partnership interests to the trusts. Is this any the less significant because the purpose was to protect the business involved from destruction? That purpose, on the contrary, explains the thoroughness and completeness with which the change was carried out. There is no method whereby petitioners could retake the partnership interests which they transferred, or distribute to themselves, or for their use or benefit, the shares of the trusts in the partnership income, as long as either the trustees do their duty or there are courts in this land.

3. In the *Tower* and *Lusthaus* cases the partnership could not be terminated without the consent of the donor partner. Here any of the trustees could by withdrawing his interest terminate the partnership.

That a power of withdrawal is proof of real ownership is shown in *Ralph W. Conant v. Com.,* 7 T. C. 577. In that case, the taxpayer created four trusts of each of which his wife was primary beneficiary. She was given the absolute power to cancel the trusts at any time and take over their corpus and undistributed income. The Court held there that that power of withdrawal prevented taxability of the income to the trustor.

4. In the *Tower* and *Lusthaus* cases the donor partner received no salary for his services to the partnership before determination of earnings divisible among the partners. Here the donor partner, petitioner, was paid for his services and such payment was deducted in arriving at the net profit divisible among the partners. The services of petitioner are therefore excluded as a factor in the case here. *John E. Goerlich v. Commissioner,* memorandum

decision of the Tax Court, Jan. 22, 1947, C. C. H. Decision No. 15,583(M).

5. In the *Tower* and *Lusthaus* cases the distributions of earnings to the donee partner, the wife, were not used or held for her separate benefit. In the *Tower* case they were used for the purposes of buying and paying for the type of things she had bought for herself, home and family before the partnership was formed. In the *Lusthaus* case they were used to pay her husband on the notes given by her as part payment of the purchase price of her alleged contribution to the partnership capital. Here, however, the distributions to the trusts were invested in securities by the trusees and accumulated for the respective beneficiaries.

C. The Decisions of the Tax Court Here Are in Direct Conflict with U. S. v. Morss (C. C. A. 1), 159 F. (2d) 142, Decided January 14, 1947, and Thomas v. Feldman (C. C. A. 5), 158 F. (2d) 488, Decided November 22, 1946.

In the *Morss* case the settlor created four trusts, one for each of four minor children, all substantially identical as to terms and form. The settlor and his wife were co-trustees. The trusts were irrevocable, with no power reserved to alter or amend. The settlor and his wife, however, as co-trustees had every conceivable power, including the power to invest the trust funds *in any partnership in which the settlor-trustee was interested as partner.* Still the Court held that the income of the trusts was not taxable to the settlor-trustee.

In the *Feldman* case the taxpayers, as here, were husband and wife holding their property as community property. They reorganized two businesses as limited partner-

ships, with taxpayer J. Feldman as general partner and a trust for the benefit of their children as limited partner. There, as here, the limited partnership interests were created by gift from the taxpayers. On the finding that the gifts creating the trusts were *"bona fide,* valid and irrevocable," that the donors ceased to be "the beneficial owners of the trust property or the recipients of the income therefrom," and that none of the income or corpus of the trust was used for their "personal benefit or economic gain," the partnership income allocated to the trust was held not taxable to the donors.

While the Tax Court's conclusion of law here was against the taxpayers its findings of fact were identical with those in the *Feldman* case, to the extent of the findings in that case. The case here, moreover, contains several additional elements which make the taxpayers' position here even stronger. There is here a finding of business purpose; of power of the trustee of any of the trusts to terminate the partnership; of compensation paid petitioner as general partner for his services.

Clearly the decisions of the Tax Court here are in conflict with the *Morss* and *Feldman* cases.

Conclusion.

The case here is not within the ambit of the *Tower* and *Lusthaus* cases. The distributive shares of the trusts in the net income of the Quon-Quon Company should therefore be taxed to the trusts and not to petitioners.

Respectfully submitted,

George T. Altman,
Attorney for Petitioners.

July 3, 1947.

APPENDIX.

Provisions of Internal Revenue Code Involved Herein.

"Sec. 11. Normal Tax on Individuals.

"There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 4 per centum of the amount of the net income in excess of the credits against net income provided in section 25."

"Sec. 12. Surtax on Individuals.

"(a) Definition of 'Surtax Net Income.'—As used in this section the term 'surtax net income' means the amount of the net income in excess of the credits against net income provided in section 25(b).

"(b) Rates of Surtax.—There shall be levied, collected, and paid for each taxable year upon the surtax net income of every individual the surtax shown in the following table: . . ."

. . . .

"Sec. 22. Gross Income.

"(a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; . . ."

. . . .

"Sec. 181. Partnership Not Taxable.

"Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

"Sec. 182. Tax of Partners.

"In computing the net income of each partner, he shall include, whether or not distribution is made to him—"

. . . .

"(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership. . . ."